Supreme Court U.S.
FILED

No. _____ 051500 MAY 23 2006

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In The

Supreme Court of the United States

COUNTY OF LOS ANGELES,

Petitioner,

vs.

NORTHROP GRUMMAN CORPORATION,

Respondent.

On Petition For Writ Of Certiorari To The California Court Of Appeal

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED FOR REVIEW

Whether federal contractor overhead property may be subject to state property tax.

PARTIES TO THE PROCEEDING

The parties to the proceeding are:

Northrop Grumman Corporation, a Delaware corporation;

and,

County of Los Angeles, a political subdivision of the State of California.

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The November 28, 2005, opinion of the California Court of Appeal, Second Appellate District, Division Two, is reported at 134 California Appellate Reports, 4th 424 [36 California Reporter 71.] See Appendix ("App.") 1-16.

JURISDICTION

The judgment of the Court of Appeal of California, Second Appellate District, was entered on November 28, 2005. On February 22, 2006, the Supreme Court of California denied a petition for hearing. (App. 17.) The jurisdiction of this Court is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

1. The Property Clause of the United States Constitution (Article IV, section 3, clause 2) provides that:

> The Congress shall have Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States; and nothing in this Constitution shall be so construed as to Prejudice any Claims of the United States, or of any particular State.

2. Subsections (a)(1) and (h) of Title 10, U.S.C. § 2307, provide:

§ 2307. Contract financing

(a) Payment authority. The head of any agency may –

(1) make advance, partial, progress, or other payments under contracts for property or services made by the agency; . . .

. . .

(h) Vesting of title in the United States. If a contract paid by a method authorized under subsection (a)(1) provides for title to property to vest in the United States, the title to the property shall vest in accordance with the terms of the contract, regardless of any security interest in the property that is asserted before or after the contract is entered into.

3. Subsection (d) of 48 C.F.R. § 52-232-16 provides:

(d) Title. (1) Title to the property described in this paragraph (d) shall vest in the Government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.

(2) Property, as used in this clause, includes all of the below-described items acquired or produced by the Contractor that are or should be allocable or properly chargeable to this contract under sound and generally accepted accounting principles and practices.

(i) Parts, materials, inventories, and work in process;

(ii) Special tooling and special test equipment to which the Government is to acquire title under any other clause of this contract;

(iii) Nondurable (i.e., noncapital) tools, jigs, dies, fixtures, molds, patterns, taps, gauges, test equipment, and other similar manufacturing aids, title to which would not be obtained as special tooling under subparagraph (ii) above; and

(iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract.

(3) Although title to property is in the Government under this clause, other applicable clauses of this contract, e.g., the termination or special tooling clauses, shall determine the handling and disposition of the property.

(4) The Contractor may sell any scrap resulting from production under this contract without requesting the Contracting Officer's approval, but the proceeds shall be credited against the costs of performance.

(5) To acquire for its own use or dispose of property to which title is vested in the Government under this clause, the Contractor must obtain the Contracting Officer's advance approval of the action and the terms. The Contractor shall (i) exclude the allocable costs of the property from the costs of contract performance, and (ii) repay to the Government any amount of unliquidated progress payments allocable to the property. Repayment may be by cash or credit memorandum.

(6) When the Contractor completes all of the obligations under this contract, including liquidation

of all progress payments, title shall vest in the Contractor for all property (or the proceeds thereof) not –

(i) Delivered to, and accepted by, the Government under this contract; or

(ii) Incorporated in supplies delivered to, and accepted by, the Government under this contract and to which title is vested in the Government under this clause.

(7) The terms of this contract concerning liability for Government-furnished property shall not apply to property to which the Government acquired title solely under this clause.

STATEMENT OF THE CASE

California law provides that all property within the state is subject to a property tax unless otherwise exempt or immune (Cal. Const., art. XIII, sec. 1), and California business personal property is subject to assessment. (See, e.g., Cal. Rev. & Tax. Code section 469.) Respondent Northrop Grumman Corporation ("Northrop") undertakes both federal and commercial contracts, and in the course of its business purchases sundry low-value equipment and supplies, referred to as overhead property. (App. 2.) For accounting purposes, overhead property is expensed upon acquisition, and is not identified to specific contracts. Its cost is recovered indirectly against all of Northrop's work. The question presented is whether Northrop's overhead property may be subject to California property tax notwithstanding that a portion is in support of federal contract activity.

Northrop brought an action below for refund of property taxes in the Los Angeles Superior Court, seeking to recover the portion of the taxes paid pertaining to expensed property for assessment years 1987-1995. A bench trial was held in the Los Angeles Superior Court on stipulated facts, and the trial court found that Northrop's overhead property was immune from California property tax in the proportion of its federal contract work to its overall business. (App. 2-3.) The County appealed to the California Court of Appeal, which affirmed the trial court's judgment in a published opinion, and opined that "Northrop's Personal Property (Overhead) is Federal Property." (*Northrop Grumman Corp. v. County of Los Angeles*, (2005) 134 Cal.App.4th 424, 433; App. 11.) The County petitioned for review with the California Supreme Court, and its petition was denied on February 22, 2006. (App. 17.)

Northrop is an engineering and manufacturing firm engaged in a substantial amount of work for the federal government. Notwithstanding its mix of government work, Northrop requires the ordinary staples of any business including office supplies, office equipment, shop supplies, shop equipment, and a technical library. Northrop expenses property and material acquired with a unit cost not exceeding its internal capitalization threshold, and not directly charged to specific contracts.

In its refund action, Northrop sought a property tax refund pertaining to the personal property identified in its cost accounting system as "perishable tools," "minor equipment," "supplies," and "technical books" and generally referred to as "overhead property."

As defined in Northrop's text of accounts, "perishable tools" consists of manufacturing sundries. The items in this account include batteries, clamps, fasteners, hammers, flashlights, knifes, soldering irons, vises, etc.

"Minor equipment" consists of new or used office equipment, machinery and equipment, and factory equipment, not meeting Northrop's capitalization threshold.

"Supplies" consist of stationery, including business cards and envelopes, drafting supplies, paints and chemicals, medical supplies, and general stores.

"Technical books" consist of reference services, periodicals, technical books, training materials, and standards.

The unit acquisition cost for each of the assets contained in these accounts did not meet Northrop's capitalization threshold, which increased over time from $500 in 1987 to $5,000 in 1995.

Northrop exercised sole discretion regarding what assets it procured pertaining to the above accounts.

Northrop maintained sole possession of the overhead property and managed its distribution and use within the Northrop organization. The types and items of the overhead property used in the performance of government contracts were often physically indistinguishable from such property used in the performance of Northrop's commercial contracts. On occasion, items of overhead property used by Northrop in the performance of both government and commercial contracts may have been commingled. (App. 2-3.)

During the tax years in question, Northrop was engaged in hundreds of contracts with the United States government. (App. 3.)

It was stipulated by the parties for purposes of this litigation that all of Northrop's government contracts during the years in question were fixed-price contracts containing the "progress payment" clause found at Title 48 C.F.R. § 52.232-16.

The management overhead property was not controlled by the United States government pursuant to Title 48 C.F.R., subpart 45.5, or Defense Federal Acquisition Regulations Supplement ("DFARS")[1] § 245.5. Northrop did not request a "proof of exemption" from the U.S. government pursuant to 48 C.F.R. § 29.305(b), nor did the U.S. government provide such proof. (App. 3.)

Overhead property is not acquired for a specific contract. The expense pertaining to the Property is accounted for as indirect cost and is allocated among all of Northrop's contracts in accordance with generally accepted accounting principles.

Overhead property is charged to Northrop's government contracts based upon a "burden" added to labor costs. The amount of the burden is based upon an estimate, which is revised annually. (Title 48 C.F.R. § 42.701.)

Northrop is engaged at any one time in hundreds of contracts, and direct labor costs are charged to individual contracts as work is completed. Overhead costs are not

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[1] The DFARS are found at 48 C.F.R. chapter 2, beginning at part 200.

charged to individual contracts. Instead, the company estimates an hourly charge required to recover over the course of its accounting year, an amount equivalent to Northrop's overhead. This estimate, called the burden rate, is then added to the hourly labor rate and charged across all of Northrop's contracts.

Northrop contends that an amount of overhead property proportional to the amount of work charged to federal contracts should be deemed immune for purposes of California property tax, arguing that the federal government is the real owner of such property. It relies for this conclusion upon an interpretation of Title 48 C.F.R. § 52.232-16(d).

Pursuant to its federal contracts, Northrop agreed to provide an end product to the government for a set price, and Northrop's profit on these contracts is the difference between the contract price and Northrop's actual costs. The government's interest is solely in receiving the end product contracted for at a set price and quality. The County concedes that the end product that the government contracted for is immune from tax.

The control of overhead costs is solely Northrop's responsibility. Corporate overhead is within Northrop's purview of control, and, because of the way profit incentives are structured in a fixed-price contract, its cost experience inures to its financial benefit or detriment. Overhead property is not a deliverable item under these contracts, and whatever interest the government takes to

such property is relinquished at the completion of the contract. (Title 48 C.F.R. § 52.232-16(d)(6).[2])

Government defense contracts are typically capital intensive and require long lead times. Consequently, the government routinely agrees to provide progress payments that are paid during the course of contract performance and debited against the contract price, though the end product contracted for by the government will only be delivered later at the completion of contract performance. Following delivery of the end product, the contract is "liquidated" and final payment is made. (Title 48 C.F.R. § 32.501; § 32.503-8.) The government's progress payments are in the nature of contract financing, and in turn the government takes a security interest in the property pertaining to the contract. However, the security interest that the government takes in property identifiable to the contract is of the highest order (described in § 52.232-16(d) as "title"), although such claim dissolves at the completion of the contract, after the end product is delivered to the government.

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[2] This subsection provides: "When the Contractor completes all of the obligations under this contract, including liquidation of all progress payments, title shall vest in the Contractor for all property (or the proceeds thereof) not –

(i) Delivered to, and accepted by, the Government under this contract; or

(ii) Incorporated in supplies delivered to, and accepted by, the Government under this contract and to which title is vested in the Government under this clause.

REASONS FOR GRANTING THE PETITION

I. Federal Contractor Overhead Property Should Not Be Immune From State Property Tax.

Contractors routinely receive progress payments from the Government for work performed on federal fixed-price contracts. In return for such payments, the government takes a security interest in the property traceable to the contract, and such property is commonly referred to as progress payment inventory. However, once the end product called for in the contract is delivered to the Government and the contract is fully executed, the government's security interest under the contract dissolves. (Title 48 C.F.R. § 52.232-16(d)(6).)

This dispute centers on Northrop's overhead property, the relatively low-value supplies and equipment acquired for its business generally and not identified to specific contracts. Northrop recovers the cost of overhead property indirectly, allocating the cost among all of its contracts, commercial and government, in accordance with generally accepted accounting principles. (App. 2.)

Modern immunity doctrine focuses on whether the legal incidence of a tax is on the government or on the contractor. The United States, its agents and instrumentalities, are immune from state tax. (*United States v. New Mexico*, 455 U.S. 720, 735 (1982).) Federal contractors, on the other hand, may be the subject of a state tax levy. (*Id.*, 455 U.S. 736.)

In this case, the tax is assessed against the contractor (not the Government) pursuant to California Revenue and Taxation Code section 405 which provides that property tax may be assessed to the person "owning, claiming, possessing, or controlling" property on the lien date.

Northrop's contracts with the Government incorporate Title 48 C.F.R. § 52-232-16, (the "Title Clause"), and Northrop asserts that this clause bars the County's assessment of its overhead property in proportion to its work on federal contracts.

Petitioner assessed Northrop for property within Northrop's control. (App. 4.) Northrop's contracts with the government are, for purposes of this litigation, of the fixed-price type, and Northrop is party to hundreds of such contracts. The government's interest in a fixed-price contract is for receipt of a specific end product. During the time a contract is being performed, the government takes an interest in the property traceable to the contract, which provides a remedy in the event of contractor default. The Government's interest in this property only becomes a consideration in the event that Northrop's performance of a fixed-price contract is deemed to be unreliable. Once the end product is delivered as called for in the contract, the government's interest in the progress payment inventory terminates.

The issue presented has important implications for the horizontal equity of California's property tax. California law requires the uniform assessment of all property except where exempt pursuant to the California Constitution, or immune under federal law. (Cal. Const., art. XIII, sec. 1.) Characterizing federal contractor overhead property as immune from tax will allow federal contractors to accumulate overhead assets on a tax preferred basis and compete for both government and commercial work on terms more favorable than those applicable to others in the business community. This favored treatment conflicts with California's constitutional policy of uniform assessment, and

is a result not otherwise required to protect the federal government's interests.

Previously the Court of Claims determined that the Title Clause was in the nature of a security interest, and that such interest was paramount to a floating lien. (*Marine Midland Bank v. United States*, 687 F.2d 395, 404 (Ct. Cl. 1982).) In 1997, Congress amended title 10 U.S.C. § 2307(h), to provide that "[i]f a contract paid by [progress payments] provides for title to property to vest in the United States, the title to the property shall vest in accordance with the terms of the contract, regardless of any security interest in the property that is asserted before or after the contract is entered into." Nonetheless, the effect of this contract financing provision is to provide the Government an ultimate priority over federal contract *property*. Conversely, property not identified to a government contract should not be deemed owned by the Government.

Like others in the business community, federal contractors require police and fire protection and other state and local government services such as courts and schools. It is reasonable that federal contractors should pay a fair share of the cost of local government, and the fact that the Government takes nominal title in contract-specific assets for the purpose of securing contract performance does not immunize a federal contractor's undifferentiated overhead assets from assessment. "... [A]bsent congressional action, we have emphasized that the states' power to tax can be denied only under 'the clearest constitutional mandate.'" (*United States v. New Mexico*, *supra*, 455 U.S. 720, 738, citing *Michelin Tire Corp. v. Wages*, 423 U.S. 276, 293 (1976).)

II. The Government's Interest In Progress Payment Inventory Extends Only To Property That Can Be Traced To A Specific Contract, And Does Not Extend To Contractor Overhead.

Federal law is ambiguous as to the extent of the Government's security interest. The respected commentators in this area, Nash & Cibinic, have opined that the extent of the Government's security interest should be defined to extend only to the *property* actually traceable to a specific contract. They state the point this way: "... [w]e've been looking at these title-vesting clauses for over 30 years and have never had any doubt that the Government was not seeking a security interest – 'title' – in contractor-acquired property charged to overhead unless the property eventually found its way into the work product called for by the contract...." (Nash & Cibinic Report, vol. 16, no. 4, April 2002, para. 19, "Postscript: Title to Overhead Items.")

A California court concurs with this perspective. In *TRW v. County of Los Angeles*, (1996) 50 Cal.App.4th 1703, 1717-1719, the Court held that the Government's interest in progress payment inventory does not extend to overhead property not directly charged to a contract.

On the other hand, other state courts have disagreed with this interpretation, finding that the federal government does take actual title to contractor overhead property. (See, e.g., *Hughes Aircraft Company v. County of Orange*, (2002) 96 Cal.App.4th 540.)

Nonetheless, regardless of whether the Government's interest under the Title Clause is deemed a security interest or full ownership, the Government's prerogatives should only extend to property traceable to a specific

contract. See, e.g., 48 C.F.R. § 32.503-14, defining progress payment inventory as encompassing title to "all of the materials, work-in-process, finished goods, and other items of property described in paragraph (d) of the Progress Payment clause *under the contract* under which progress payments have been made. . . . " Also, 48 C.F.R. § 52.245-2(c)(4) refers to "material" in a fixed-price contract as a direct item of cost. Overhead property, on the other hand, is typically purchased in bulk and is not traced to specific contracts. The Title Clause should not bar local assessment of overhead property not otherwise identified to a federal contract.

The *Northrop* court observed that the purpose of the Title Clause is to preserve the Government's ability to reclaim "war material" without the burdens of extended litigation. (App. 9-10.) However, with Respondent having hundreds of contracts and a mixed book of commercial and government business, a reasonable application of the Title Clause should distinguish between undifferentiated corporate property in contrast to other property that is earmarked to specific commercial or government contracts. The County admits that property identified to a specific government contract is beyond the power of the County to assess. However, property in a commercial entity's control, not earmarked to a specific government contract, should be amenable to a non-discriminatory state property tax assessment.

III. The Federal Government Does Not Take Beneficial Ownership Of The Disputed Property.

The Government's procedures and practices regarding progress payment inventory support the Petitioner's

position. Progress payment inventory is not subject to government property management regulations. (48 C.F.R. § 45.000.) It is not managed as government-owned property, nor is it annually reported to the government on DD form 1662, "DOD Property in the Custody of Contractors." Indeed, the Government's practice of releasing its interest in progress payment inventory at the conclusion of a government contract is inconsistent with a characterization of progress payment inventory as government-owned property in a conventional sense. A more accurate view is that the Government's interest in progress payment inventory is in the nature of a paramount security interest that is exercised by the Government when a federal contractor defaults in contract performance and then extends to property identifiable to a specific contract.

California's property tax system is grounded upon the promise of uniform and equal assessments. County assessors, who levy the great majority of California property tax assessments, routinely disregard trust deeds, mortgages, and other forms of security interests in making their assessments. The Title Clause at the heart of this case is in effect a paramount security interest and would be routinely disregarded for assessment purposes were this case not to concern federal contracts. (See, e.g., 18 Cal. Code of Regulations, §462.240(a) [transfers of bare legal title and security interests disregarded for purposes of property tax reassessment in California]; *Mayhew TechCenter, Phase II v. County of Sacramento*, (1992) 4 Cal.App.4th 497, 505-506.)

Respondent asserts the Title Clause as a basis to minimize its tax burden. However, the Title Clause is intended to provide security to the Government in the event of contractor default. Overhead property should not be immune from a state and local property tax assessment

unless the Government takes overhead property into actual possession, or where such overhead property is in fact identified to a specific government contract. Northrop's overhead is in its possession and control and should not be deemed immune from California property tax on account of its fixed-price contracts.

This case raises an important question of law concerning the extent to which federal procurement law bears on the power of state and local government to levy a property tax assessment, and this is the sole federal forum available to Petitioner to examine the issue.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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May 2006

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CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRICT

DIVISION TWO

NORTHROP GRUMMAN CORPORATION, Plaintiff and Appellant, v. COUNTY OF LOS ANGELES, Defendant and Appellant.	B172863 (Los Angeles County Super. Ct. No. BC279303 (Filed Nov. 28, 2005)

APPEALS from a judgment of the Superior Court of Los Angeles County. Ronald M. Sohigian, Judge. Affirmed.

Raymond G. Fortner, Jr., County Counsel, Albert Ramseyer, Principal Deputy County Counsel, for Defendant and Appellant.

Bewley, Lassleben & Miller, Jeffrey S. Baird, Joseph A. Vinatieri, Kevin P. Duthoy, Jason C. DeMille, for Plaintiff and Appellant.

The County of Los Angeles assessed ad valorem property taxes on personal property allocated by a military defense contractor to the performance of its fixed-price contracts with the United States government. The progress payment clause of the federal contracts states that title to property allocable or chargeable to the contracts vests in the federal government. The County interprets this to mean that the United States takes a lien or security

interest in the contractor's property. We disagree with the County's interpretation. Title means title. Title does not mean lien. Because the County cannot tax property owned by the United States, it must refund the taxes paid by the contractor on property allocated to the performance of its military contracts.

FACTS[1]

Northrop Grumman Corporation (Northrop) is a Los Angeles County (County) contractor primarily engaged in the business of designing and building military aircraft and weapons systems for the United States government. It also manufactures commercial aircraft. Northrop uses four categories of personal property in its business: perishable tools, minor equipment, supplies, and technical books.[2]

During the tax years in question, 1987 through 1995, Northrop's personal property (i.e., its tools, minor equipment, supplies and technical books) was accounted for as an indirect (overhead) cost, which was allocated among all of Northrop's contracts in accordance with generally accepted accounting principles. Northrop exercised sole discretion regarding the type of tools, equipment, supplies

[1] The parties stipulated to the facts underpinning this lawsuit.

[2] "Perishable equipment" includes bolts, cloths, adapters, batteries, bits, blades, brushes, clamps, dyes, drills, fasteners, files, flashlights, gauges, hammers, knives, mallets, wrenches, and so on. "Minor equipment" covers office equipment, machinery, and factory equipment. "Supplies" encompass materials on hand that do not enter directly into finished products but are necessary for day-to-day work, such as pens, paper, safety equipment, paint, chemicals, oils, acids, adhesive, tape, gloves, towels, and so on. "Technical books" include government or aerospace industry publications used by Northrop to perform its contracts.

and books it procured, and maintained sole possession of them. At times, tools and supplies used by Northrop in the performance of both government and commercial contracts may have been commingled. For example, personnel on assembly lines in Hawthorne may have interchanged tools among the 747 commercial aircraft and F-18 fighter aircraft projects, because the tools, equipment and supplies used in both assembly lines were physically indistinguishable.

Northrop believes, and the County disputes, that part of Northrop's personal property is owned by the United States government and is therefore exempt from property taxes. Northrop did not request a "proof of exemption" from the federal government, nor was one provided. Nevertheless, it is undisputed that Northrop designed, fabricated and delivered military aircraft to the federal government under hundreds of fixed-price contracts during the relevant tax years. The fixed-price contracts contain a clause providing for progress payments.

Northrop filed numerous claims with the County seeking a refund of taxes it paid on its personal property. In itemized refund claim calculations, Northrop identified the percentage of its personal property allocable to the performance of its military contracts with the federal government. Northrop's total refund request for the tax years 1987 to 1995 is $2,268,451. The County denied Northrop's refund claims.

In 2002, Northrop filed suit against the County, demanding payment of its tax refund. The dispute was tried by the court, which gave judgment to Northrop. The County has appealed from the judgment and Northrop has

cross-appealed to challenge the court's computation of prejudgment interest. The appeals are timely.

DISCUSSION

The County's Appeal

1. Appeal and Review

Appeal lies from the judgment. (Code Civ. Proc., § 904.1, subd. (a)(1).) The classification of items as taxable or nontaxable presents a question of law that is reviewed independently on appeal. (*Crocker National Bank v. City and County of San Francisco* (1989) 49 Cal.3d 881, 888.) "Taxation must, of course, be uniform and the tax law uniformly applied. [Citation.] Uniformity depends on proper classification. And proper classification is furthered through the application of independent review." (*Id.* at pp. 888-889.) The construction of contracts to which the United States is a party, the effect of the contracts on the rights and obligations of the signatories, and the titles or liens created by the contracts present questions of federal law. (*U.S. v. Allegheny County* (1944) 322 U.S. 174, 183.)

2. Extent of the County's Right to Levy on a Federal Contractor's Property

The County is generally entitled to assess levies on taxable property. (Rev. & Tax Code, § 405; *General Dynamics Corp. v. County of L.A.* (1958) 51 Cal.2d 59, 63-66.) The County is not, however, entitled to collect taxes on property owned by the federal government: the United States is immune from direct state and local taxation. (*United States v. California* (1993) 507 U.S. 746, 753; *M'Culloch v. State of Maryland* (1819) 17 U.S. 316, 436.) "[T]he

Government's property interests are not taxable either to it or to its bailee. The 'Government' is an abstraction, and its possession of property largely constructive. Actual possession and custody of Government property nearly always are in someone who is not himself the Government but acts in its behalf and for its purposes. He may be an officer, an agent, or a contractor. His personal advantages from the relationship by way of salary, profit, or beneficial personal use of the property may be taxed as we have held. But neither he nor the Government can be taxed for the Government's property interest." (*U.S. v. Allegheny County, supra,* 322 U.S. at pp. 187-188.)

Thus, the federal immunity from state taxes may extend to a federal contractor. "[W]here the federal government receives title to property pursuant to the provision of its contract with a civilian contractor, any use of the property made by the contractor in performing the contract after title has passed to the government under the terms of the contract is deemed to have been made on behalf of the government and such use therefore is not taxable." (*Aerospace Corp. v. State Bd. of Equalization* (1990) 218 Cal.App.3d 1300, 1309-1310; *Lockheed Aircraft Corp. v. State Bd. of Equalization* (1978) 81 Cal.App.3d 257, 266-267.)

In sum, ad valorem property taxes cannot be imposed if the property belongs to the federal government, not the contractor. However, an ad valorem property tax can be imposed on property belonging to the federal contractor and not to the federal government. (*TRW Space & Defense Sector v. County of Los Angeles* (1996) 50 Cal.App.4th 1703, 1713-1714 (*TRW*); *Hughes Aircraft Co. v. County of Orange* (2002) 96 Cal.App.4th 540, 545 (*Hughes*).) With respect to federal contractors, government property is

"'"all property owned by or leased to the Government or acquired by the Government under the terms of the contract. It includes both Government-furnished property and contractor-acquired property as defined in this section." [Citation.] Contractor-acquired property "means property acquired or otherwise provided by the contractor for performing a contract and to which the Government has title. . . ." [Citation.]'" (*Hughes, supra,* 96 Cal.App.4th at p. 552, fn. 5, quoting the Federal Acquisition Regulation (FAR), 48 C.F.R. § 45.101(a).)

3. Federal Title: Ownership or Security Interest in Northrop's Property?

Northrop's contracts with the federal government are fixed-price contracts. In these contracts, the agreed consideration is fixed and the work is financed by the government with progress payments based on the contractor's periodic invoices. (48 C.F.R. § 52.232-16.) The question raised by the County is whether, under a fixed-price contract with progress payments, the federal government takes *title* to the contractor's personal property, or merely takes a *lien or security interest* in the contractor's personal property.

The contracts between the United States and Northrop state, on their face, that the federal government takes title to specified portions of Northrop's personal property. The progress payment clause reads, "(d) Title. (1) Title to the property described in this paragraph (d) shall vest in the Government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly

chargeable to this contract."[3] Identical language appears in the FAR, 48 Code of Federal Regulations part 52.232-16(d). "The FAR sets forth the Government's policies with respect to progress payments. Progress payments are made on the basis of costs incurred by the contractor as work progresses under the contract. Upon contract formation, or as property becomes allocable to a contract, title vests in the Government. The Government takes title to parts, materials, inventories, work in progress, special tooling, nondurable tools, and drawings and technical data developed as part of the contract." (Sainsbury, *Seeking One Rule to Bind Them: Unifying the Interpretation and Treatment of the "Title-Vesting" Language of the Progress Payments Clause* (2003) 32 Pub Cont. L.J. 327, 335, fns. omitted.)

For nearly 100 years, the courts have confirmed that the federal government takes title to its contractors' property in exchange for progress payments. In 1910, the Supreme Court held that progress payments to a shipbuilder vested title to the contractor's property in the federal government, as provided in the federal contract. (*United States v. Ansonia Brass & Copper Co.* (1910) 218 U.S. 452, 466-467.) The plain and literal language of the contractual title-vesting clause was likewise enforced in *In re Read-York* (7th Cir. 1945) 152 F.2d 313, 316; *In re American Boiler Works* (3d Cir. 1955) 220 F.2d 319, 320-321; *Shepard Engineering Company v. United States* (8th Cir. 1961) 287 F.2d 737, 741; and *General Dynamics Corp. v. County of L.A., supra,* 51 Cal.2d at pages 69-71.

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[3] The specific property covered by paragraph (d) of the contract is discussed in section 4, *post.*

More recently, the Congress underscored the title-passing effect of fixed-price contracts by adding supportive language to the National Defense Authorization Act for Fiscal Year 1998. (Pub. L. No 105-85 (Nov. 18, 1997) div. A, tit. VIII, subtit. A (Amendments to General Contracting Authorities, Procedures, and Limitations) § 802, 111 Stat. 1831.) Reconfirming the validity of the title-passing provisions of the FAR, the new statutory language declares that title to a military contractor's property shall vest in the federal government if the contractor receives progress payments. It states that an agency may make progress payments or other payments under contracts for property or services. If the contract "provides for title to property to vest in the United States, the title to the property shall vest in accordance with the terms of the contract, regardless of any security interest in the property that is asserted before or after the contract is entered into." (10 U.S.C. § 2307(h).)

The federal courts have generally resisted the notion that the government's interest in a contractor's work-in-progress was in the nature of a lien or security interest, rather than an ownership interest. Early cases rejecting the security interest argument include *Boeing Company v. United States* (Ct.Cl. 1964) 338 F.2d 342, 345-346, and *In re Double H Products Corporation* (3d Cir. 1972) 462 F.2d 52, 55-57.

In 1982, the federal Court of Claims took an entirely new tack and declared that the federal government takes a lien interest, not title, to its contractors' property. In *Midland Marine Bank v. United States* (Ct.Cl. 1982) 687 F.2d 395 (*Marine Midland*), a case that the County relies upon in support of its position, the court characterized the government's progress payments as "loans" to the contractor,

with no incidence of government ownership. The government took only a security interest in the contractor's inventory, the court reasoned, which "was far less than full ownership." (*Id.* at p. 398.) The reasoning of *Marine Midland* represents a departure from the case law that preceded it.

As one court has observed, "A respectable body of law criticizes the reasoning of *Marine Midland* and holds that, when, under a title vesting clause, a government contrac tor acquires property allocable to the contract or its completion, government obtains absolute title to the property and subsequent liens cannot be asserted against that property to defeat the government's interest. . . ." (*First National Bank of Geneva v. United States* (Ct.Cl. 1987) 13 Cl. Ct. 385, 387.)[4]

A literal reading of the title-vesting provision is particularly compelling in the context of military contracts, when the contracted-for goods are needed for national defense. (*In re Coated Sales, Inc.* (Bankr. S.D.N.Y. 1988) 112 B.R. 560, 562.) Northrop manufactures military jets and weapons systems for the United States. If Northrop or another defense contractor were to declare bankruptcy or otherwise terminate operations, essential military production could be jeopardized, potentially for years,

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[4] Among the cases criticizing *Marine Midland* as being wrongly decided are *In re American Pouch Foods, Inc.* (7th Cir. 1985) 769 F.2d 1190, 1195-1196 [under title vesting provisions in a progress payment contract, the federal government is entitled to immediate possession of materials used by a defaulting contractor who produced meals-ready-to-eat for the military]; *In re Economy Cab and Tool Co., Inc.* (Bankr. D.Minn. 1985) 47 B.R. 708, 711, fn. 3; *In re Reynolds Mfg. Co.* (Bankr. W.D.Pa. 1986) 68 B.R. 219, 223-224; *McDonnell Douglas v. Director of Revenue* (Mo. 1997) 945 S.W.2d 437, 441.)

while the federal government, creditors, shareholders, and a bankruptcy trustee squabble over the assets that the contracting business uses to produce the items needed for national defense.[5] A literal reading of the title-vesting clause affords the federal government protection from detrimental protracted litigation over war material because absolute title is superior to the interests claimed by secured creditors or bankruptcy trustees.

We shall not follow *Marine Midland,* and instead follow the majority rule that the United States takes title to all property used in the performance of federal defense contracts under the title-vesting clause. First, in 1910, the Supreme Court interpreted the clause to confer title on the federal government in *United States v. Ansonia Brass & Copper Co., supra* 218 U.S. 452. Second, the contractual language, on its face, confers title, not a mere security interest. Third, in 1998, the Congress declared that title to a federal armed forces contractor's property does, in fact, vest in the federal government if the contractor receives progress payments. (10 U.S.C. § 2307(h).) Presumably, Congress was aware of the 1982 *Marine Midland* case and intended to abrogate its holding by enacting a statute that expressly confers *title,* not a mere *lien.* When Congress has yet to enact a law, it is the role of the federal courts "to fashion the governing rule of law according to their own standards." (*Clearfield Trust Co. v. U.S.* (1943) 318 U.S. 363, 367.) Congress has now spoken, and it did not adopt the rule fashioned in *Marine Midland.* Neither do we.

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[5] In the case of *In re American Pouch Foods, Inc., supra,* 769 F.2d 1190, for example, five years of bankruptcy litigation were needed before the government succeeded in asserting ownership and possession of a defaulting defense contractor's materials.

4. Northrop's Personal Property (Overhead) Is Federal Property

The County maintains that "business sundries" purchased by Northrop are not exempt from property taxes. The County reasons that such property is not traceable to or earmarked for a specific government contract; therefore, it is Northrop's property and is taxable. Northrop counters that all of the overhead material that the County seeks to tax is nontaxable federal property because it was allocated to federal contracts.

Under 48 Code of Federal Regulations part 52.232-16(d) (2004) and the terms of Northrop's contracts, the government takes title to the contractor's "property." Property "includes all of the below-described items acquired or produced by the Contractor that are or should be allocable or properly chargeable to this contract under sound and generally accepted accounting principles and practices. (i) Parts, materials, inventories, and work in process; (ii) Special tooling and special test equipment to which the Government is to acquire title under any other clause of this contract; (iii) Nondurable (i.e., noncapital) tools, jigs, dies, fixtures, molds, patterns, taps, gauges, test equipment, and similar manufacturing aids, title to which would not be obtained as special tooling . . . ; and (iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract."[6]

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[6] "Material" is property incorporated into an end-product or consumed or expended in performing a contract. It includes parts, components, small tools "and supplies that may be consumed in normal use in performing a contract." (48 C.F.R. § 45.301 (2004).)

In *Aerospace Corp. v. State Bd. of Equalization, supra,* 218 Cal.App.3d 1300, the issue was whether title passed to the federal government for overhead materials charged to the government as an indirect cost. The materials included batteries, hammers, drills, stationery and janitorial supplies purchased by Aerospace Corp. The court held that because title to this overhead material passed to the government in accordance with the contract, it was not subject to sales and use taxes. (*Id.* at pp. 1309-1310.)

The County relies primarily on an opinion from Division Four of this District, which allowed taxation of a federal contractor's overhead property. (*TRW, supra,* 50 Cal.App.4th 1703.) The court in *TRW* determined that the only portion of the contractor's property belonging to the federal government "is that which is used to produce the item contracted for," such as "parts, instrumentalities or design and technical drawings pertinent to the production and operation of the product." However, the court continued, overhead items such as Post-It notes, stationery, toilet paper, and desks are not used to produce the contracted-for items and are therefore not government property. (*Id.* at pp. 1718-1719.)

The court's reasoning in *TRW* has been criticized and rejected in this state and elsewhere. No court has followed *TRW. TRW* was rejected by the Fourth District in the *Hughes* case, *supra,* 96 Cal.App.4th 540. There, the court noted that overhead items "'need not be identifiable to a single contract to constitute [G]overnment property'" under the title-passing clause. (*Hughes,* at p. 554.) Thus, title to such personal property as materials consumed in the production process, general office supplies, equipment and office partitions, allocable to the government, vested in the government. The court determined that the allocable

property listed in the FAR (48 C.F.R. § 52.232-16-(d), *supra*) was nonexclusive, so overhead items were not excluded even if not expressly mentioned in the FAR. (*Hughes,* at pp. 550-551.) Similarly, an appeals court in Arizona concluded that a federal contractor could not be assessed for delinquent taxes on items purchased as indirect cost (overhead) property allocated to various federal and private contracts. The court held that title to these items passed to the government under fixed-price contracts. (*Motorola, Inc. v. Arizona Dept. of Revenue* (App.1999) 993 P.2d 1101, 1106-1107.)[7]

In a recent Texas case, a military defense contractor purchased many different items of tangible personal property in performing its contracts. Some items were directly tied to a particular contract; other items such as office supplies were indirect overhead costs charged across multiple government and private contracts. (*Strayhorn v. Raytheon E-Systems, Inc.* (Tex.App. 2003) 101 S.W.3d 558, 564-565.) The dispute was whether the state could impose a sales tax on Raytheon's purchase of overhead items charged as indirect costs to government contracts. (*Id.* at p. 565.) The court concluded that "the government obtains title to overhead items charged as indirect costs to government contracts at the time the costs are allocated to the contracts," a rule that extends to "pencils and other office supplies." (*Id.* at pp. 566-567.)

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[7] The overhead items included parts (e.g., batteries), materials (e.g., metal, plastics), low-value plant equipment (e.g., timers, meters, amplifiers), perishable tools (e.g., hammers, drills, screwdrivers), office equipment (e.g., typewriter stands, card files), office supplies (e.g., stationery, paper clips), and other miscellaneous items (e.g., glue, nuts, bolts, etc.) and even employee awards, plaques and cakes served at employee functions. (993 P.2d at pp. 1103-1104.)

We shall follow the better-reasoned decision in *Hughes,* and decline to follow the *TRW* case. We conclude that overhead property allocated to government contracts as an indirect cost becomes the property of the federal government and is therefore not taxable.

Northrop's Cross-Appeal

The trial court awarded Northrop prejudgment interest beginning upon the dates that Northrop filed tax refund claims. In its cross-appeal, Northrop argues that it is entitled to prejudgment interest commencing on the date it made each tax payment to the County. The County contends that interest did not start accruing until Northrop filed refund claims.

A taxpayer who challenges the imposition of a property tax has two administrative remedies available. One remedy is to apply for an assessment reduction (an "assessment appeal") under Revenue and Taxation Code section 1603. The other remedy is to file a claim for a refund under Revenue and Taxation Code sections 5096 et seq. Filing a claim for a refund is a prerequisite to pursuing a refund action. (Rev. & Tax. Code, § 5142.) Northrop elected to file a claim for a refund, but did not apply for an assessment reduction.

The parties agree that a taxpayer is ordinarily required to apply for an assessment reduction to receive full prejudgment interest from the date the tax was paid. (Rev. & Tax. Code, § 5151, subd. (c)(1)(A), (c)(3).)[5] Though Northrop

[5] "(c)(1) The interest computation period shall commence with the date of payment of the tax when any of the following apply: (A) A timely application for reduction in an assessment was filed . . . (3) In all other

(Continued on following page)

did not apply for an assessment reduction, the company argues that it is nevertheless entitled to full prejudgment interest because of a factual stipulation made by the County. The stipulation reads, "The refund claims . . . were timely filed with County in accordance with Revenue and Taxation Code section 5097(a)(2). Northrop exhausted its administrative remedies with respect to each refund claim." Northrop interprets this to be an admission by the County that Northrop exhausted its remedies as to an assessment reduction application.

Northrop's reading of the stipulation is too broad. The County only agreed that Northrop exhausted its administrative remedies with respect to "each refund claim." The County did not stipulate that Northrop exhausted its remedies with respect to any application for an assessment reduction. As a fall-back argument, Northrop asserts that it would have been futile to pursue an application for an assessment reduction with the County because the County lacked jurisdiction to consider the type of claim being made by Northrop. (See *TRW, supra,* 50 Cal.App.4th at p. 1710.)

The problem for Northrop is that the award of prejudgment interest is purely statutory, and there is no statute authorizing interest from the date the tax is paid when the taxpayer pursues a claim for a refund. The only statutory authorization for the interest Northrop desires occurs when the taxpayer pursues an assessment reduction, which Northrop did not or could not do. As a result, Northrop is limited to collecting interest from the date it

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cases the interest computation period shall commence on the date of filing a claim for refund. . . ." (Rev. & Tax. Code, § 5151.)

filed its claim for a refund, as the trial court correctly found.

DISPOSITION

The judgment is affirmed.

CERTIFIED FOR PUBLICATION

BOREN, P.J.

We concur:

DOI TODD, J.

ASHMANN-GERST, J.

Court of Appeal, Second Appellate District,
Division Two – No. B172863
S140304

IN THE SUPREME COURT OF CALIFORNIA

En Banc

NORTHROP GRUMMAN CORPORATION,
Plaintiff and Appellant,

v.

COUNTY OF LOS ANGELES,
Defendant and Appellant.

(Filed Feb. 22, 2006)

Petition for review DENIED.

/s/ George
Chief Justice

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48 C.F.R. § **52.232-16** Progress Payments.

As prescribed in 32.502-4(a), insert the following clause:

Progress Payments (April 2003)

The Government will make progress payments to the Contractor when requested as work progresses, but not more frequently than monthly, in amounts of $2,500 or more approved by the Contracting Officer, under the following conditions:

(a) Computation of amounts. (1) Unless the Contractor requests a smaller amount, the Government will compute each progress payment as 80 percent of the Contractor's total costs incurred under this contract whether or not actually paid, plus financing payments to subcontractors (see paragraph (j) of this clause), less the sum of all previous progress payments made by the Government under this contract. The Contracting Officer will consider cost of money that would be allowable under FAR 31.205-10 as an incurred cost for progress payment purposes.

(2) The amount of financing and other payments for supplies and services purchased directly for the contract are limited to the amounts that have been paid by cash, check, or other forms of payment, or that are determined due and will be paid to subcontractors –

(i) In accordance with the terms and conditions of a subcontract or invoice; and

(ii) Ordinarily within 30 days of the submission of the Contractor's payment request to the Government.

(3) The Government will exclude accrued costs of Contractor contributions under employee pension plans until actually paid unless –

(i) The Contractor's practice is to make contributions to the retirement fund quarterly or more frequently; and

(ii) The contribution does not remain unpaid 30 days after the end of the applicable quarter or shorter payment period (any contribution remaining unpaid shall be excluded from the Contractor's total costs for progress payments until paid).

(4) The Contractor shall not include the following in total costs for progress payment purposes in paragraph (a)(1) of this clause:

(i) Costs that are not reasonable, allocable to this contract, and consistent with sound and generally accepted accounting principles and practices.

(ii) Costs incurred by subcontractors or suppliers.

(iii) Costs ordinarily capitalized and subject to depreciation or amortization except for the properly depreciated or amortized portion of such costs.

(iv) Payments made or amounts payable to subcontractors or suppliers, except for –

(A) Completed work, including partial deliveries, to which the Contractor has acquired title; and

(B) Work under cost-reimbursement or time-and-material subcontracts to which the Contractor has acquired title.

(5) The amount of unliquidated progress payments may exceed neither (i) the progress payments made against incomplete work (including allowable unliquidated progress payments to subcontractors) nor (ii) the value, for progress payment purposes, of the incomplete work. Incomplete work shall be considered to be the supplies and services required by this contract, for which delivery and invoicing by the Contractor and acceptance by the Government are incomplete.

(6) The total amount of progress payments shall not exceed 80 percent of the total contract price.

(7) If a progress payment or the unliquidated progress payments exceed the amounts permitted by subparagraphs (a)(4) or (a)(5) above, the Contractor shall repay the amount of such excess to the Government on demand.

(8) Notwithstanding any other terms of the contract, the Contractor agrees not to request progress payments in dollar amounts of less than $2,500. The Contracting Officer may make exceptions.

(b) Liquidation. Except as provided in the Termination for Convenience of the Government clause, all progress payments shall be liquidated by deducting from any payment under this contract, other than advance or progress payments, the unliquidated progress payments, or 80 percent of the amount invoiced, whichever is less. The Contractor shall repay to the Government any amounts required by a retroactive price reduction, after computing liquidations and payments on past invoices at the reduced prices and adjusting the unliquidated progress payments accordingly. The Government reserves the right to unilaterally change from the ordinary liquidation

rate to an alternate rate when deemed appropriate for proper contract financing.

(c) Reduction or suspension. The Contracting Officer may reduce or suspend progress payments, increase the rate of liquidation, or take a combination of these acquisitions, after finding on substantial evidence any of the following conditions:

(1) The Contractor failed to comply with any material requirement of this contract (which includes paragraphs (f) and (g) below).

(2) Performance of this contract is endangered by the Contractor's

(i) failure to make progress or

(ii) unsatisfactory financial condition.

(3) Inventory allocated to this contract substantially exceeds reasonable requirements.

(4) The Contractor is delinquent in payment of the costs of performing this contract in the ordinary course of business.

(5) The unliquidated progress payments exceed the fair value of the work accomplished on the undelivered portion of this contract.

(6) The Contractor is realizing less profit than that reflected in the establishment of any alternate liquidation rate in paragraph (b) above, and that rate is less than the progress payment rate stated in subparagraph (a)(1) above.

(d) Title.

(1) Title to the property described in this paragraph (d) shall vest in the Government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.

(2) Property, as used in this clause, includes all of the below-described items acquired or produced by the Contractor that are or should be allocable or properly chargeable to this contract under sound and generally accepted accounting principles and practices.

(i) Parts, materials, inventories, and work in process;

(ii) Special tooling and special test equipment to which the Government is to acquire title under any other clause of this contract;

(iii) Nondurable (i.e., noncapital) tools, jigs, dies, fixtures, molds, patterns, taps, gauges, test equipment, and other similar manufacturing aids, title to which would not be obtained as special tooling under subparagraph (ii) above; and

(iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract.

(3) Although title to property is in the Government under this clause, other applicable clauses of this contract, e.g., the termination or special tooling clauses, shall determine the handling and disposition of the property.

(4) The Contractor may sell any scrap resulting from production under this contract without requesting the

Contracting Officer's approval, but the proceeds shall be credited against the costs of performance.

(5) To acquire for its own use or dispose of property to which title is vested in the Government under this clause, the Contractor must obtain the Contracting Officer's advance approval of the action and the terms. The Contractor shall (i) exclude the allocable costs of the property from the costs of contract performance, and (ii) repay to the Government any amount of unliquidated progress payments allocable to the property. Repayment may be by cash or credit memorandum.

(6) When the Contractor completes all of the obligations under this contract, including liquidation of all progress payments, title shall vest in the Contractor for all property (or the proceeds thereof) not –

(i) Delivered to, and accepted by, the Government under this contract; or

(ii) Incorporated in supplies delivered to, and accepted by, the Government under this contract and to which title is vested in the Government under this clause.

(7) The terms of this contract concerning liability for Government-furnished property shall not apply to property to which the Government acquired title solely under this clause.

(e) Risk of loss. Before delivery to and acceptance by the Government, the Contractor shall bear the risk of loss for property, the title to which vests in the Government under this clause, except to the extent the Government expressly assumes the risk. The Contractor shall repay the Government an amount equal to the unliquidated progress

payments that are based on costs allocable to property that is damaged, lost, stolen, or destroyed.

(f) Control of costs and property. The Contractor shall maintain an accounting system and controls adequate for the proper administration of this clause.

(g) Reports and access to records. The Contractor shall promptly furnish reports, certificates, financial statements, and other pertinent information reasonably requested by the Contracting Officer for the administration of this clause. Also, the Contractor shall give the Government reasonable opportunity to examine and verify the Contractor's books, records, and accounts.

(h) Special terms regarding default. If this contract is terminated under the Default clause,

(i) the Contractor shall, on demand, repay to the Government the amount of unliquidated progress payments and

(ii) title shall vest in the Contractor, on full liquidation of progress payments, for all property for which the Government elects not to require delivery under the Default clause. The Government shall be liable for no payment except as provided by the Default clause.

(i) Reservations of rights.

(1) No payment or vesting of title under this clause shall

(i) excuse the Contractor from performance of obligations under this contract or

(ii) constitute a waiver of any of the rights or remedies of the parties under the contract.

(2) The Government's rights and remedies under this clause

(i) shall not be exclusive but rather shall be in addition to any other rights and remedies provided by law or this contract and

(ii) shall not be affected by delayed, partial, or omitted exercise of any right, remedy, power, or privilege, nor shall such exercise or any single exercise preclude or impair any further exercise under this clause or the exercise of any other right, power, or privilege of the Government.

(j) Financing payments to subcontractors. The financing payments to subcontractors mentioned in paragraphs (a)(1) and (a)(2) of this clause shall be all financing payments to subcontractors or divisions, if the following conditions are met:

(1) The amounts included are limited to –

(i) The unliquidated remainder of financing payments made; plus

(ii) Any unpaid subcontractor requests for financing payments.

(2) The subcontract or interdivisional order is expected to involve a minimum of approximately 6 months between the beginning of work and the first delivery; or, if the subcontractor is a small business concern, 4 months.

(3) If the financing payments are in the form of progress payments, the terms of the subcontract or interdivisional order concerning progress payments –

(i) Are substantially similar to the terms of this clause for any subcontractor that is a large business concern, or

this clause with its Alternate I for any subcontractor that is a small business concern;

(ii) Are at least as favorable to the Government as the terms of this clause;

(iii) Are not more favorable to the subcontractor or division than the terms of this clause are to the Contractor;

(iv) Are in conformance with the requirements of FAR 32.504(e); and

(v) Subordinate all subcontractor rights concerning property to which the Government has title under the subcontract to the Government's right to require delivery of the property to the Government if –

(A) The Contractor defaults; or

(B) The subcontractor becomes bankrupt or insolvent.

(4) If the financing payments are in the form of performance-based payments, the terms of the subcontract or interdivisional order concerning payments –

(i) Are substantially similar to the Performance-Based Payments clause at FAR 52.232-32 and meet the criteria for, and definition of, performance-based payments in FAR Part 32;

(ii) Are in conformance with the requirements of FAR 32.504(f); and

(iii) Subordinate all subcontractor rights concerning property to which the Government has title under the subcontract to the Government's right to require delivery of the property to the Government if –

(A) The Contractor defaults; or

(B) The subcontractor becomes bankrupt or insolvent.

(5) If the financing payments are in the form of commercial item financing payments, the terms of the subcontract or interdivisional order concerning payments –

(i) Are constructed in accordance with FAR 32.206(c) and included in a subcontract for a commercial item purchase that meets the definition and standards for acquisition of commercial items in FAR Parts 2 and 12;

(ii) Are in conformance with the requirements of FAR 32.504(g); and

(iii) Subordinate all subcontractor rights concerning property to which the Government has title under the subcontract to the Government's right to require delivery of the property to the Government if –

(A) The Contractor defaults; or

(B) The subcontractor becomes bankrupt or insolvent.

(6) If financing is in the form of progress payments, the progress payment rate in the subcontract is the customary rate used by the contracting agency, depending on whether the subcontractor is or is not a small business concern.

(7) Concerning any proceeds received by the Government for property to which title has vested in the Government under the subcontract terms, the parties agree that the proceeds shall be applied to reducing any unliquidated financing payments by the Government to the Contractor under this contract.

(8) If no unliquidated financing payments to the Contractor remain, but there are unliquidated financing payments that the Contractor has made to any subcontractor, the Contractor shall be subrogated to all the rights the Government obtained through the terms required by this clause to be in any subcontract, as if all such rights had been assigned and transferred to the Contractor.

(9) To facilitate small business participation in subcontracting under this contract, the Contractor shall provide financing payments to small business concerns, in conformity with the standards for customary contract financing payments stated in FAR 32.113. The Contractor shall not consider the need for such financing payments as a handicap or adverse factor in the award of subcontracts.

(k) Limitations on Undefinitized Contract Actions. Notwithstanding any other progress payment provisions in this contract, progress payments may not exceed 80 percent of costs incurred on work accomplished under undefinitized contract actions. A contract action is any action resulting in a contract, as defined in Subpart 2.1, including contract modifications for additional supplies or services, but not including contract modifications that are within the scope and under the terms of the contract, such as contract modifications issued pursuant to the Changes clause, or funding and other administrative changes. This limitation shall apply to the costs incurred, as computed in accordance with paragraph (a) of this clause, and shall remain in effect until the contract action is definitized. Costs incurred which are subject to this limitation shall be segregated on Contractor progress payment requests and invoices from those costs eligible for higher progress payment rates. For purposes of progress payment liquidation, as described in paragraph (b) of this clause, progress

payments for undefinitized contract actions shall be liquidated at 80 percent of the amount invoiced for work performed under the undefinitized contract action as long as the contract action remains undefinitized. The amount of unliquidated progress payments for undefinitized contract actions shall not exceed 80 percent of the maximum liability of the Government under the undefinitized contract action or such lower limit specified elsewhere in the contract. Separate limits may be specified for separate actions.

(l) Due date. The designated payment office will make progress payments on the ____ [Contracting Officer insert date as prescribed by agency head; if not prescribed, insert "30th"] day after the designated billing office receives a proper progress payment request. In the event that the Government requires an audit or other review of a specific progress payment request to ensure compliance with the terms and conditions of the contract, the designated payment office is not compelled to make payment by the specified due date. Progress payments are considered contract financing and are not subject to the interest penalty provisions of the Prompt Payment Act.

(m) Progress payments under indefinite – delivery contracts. The Contractor shall account for and submit progress payment requests under individual orders as if the order constituted a separate contract, unless otherwise specified in this contract.

(End of clause)

(1)

Supreme Court, U.S.
FILED
JUL 25 2006
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No. 05-1500

IN THE

Supreme Court of the United States

COUNTY OF LOS ANGELES,

Petitioner,

v.

NORTHROP GRUMMAN CORPORATION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE CALIFORNIA COURT OF APPEAL, SECOND APPELLATE DEPARTMENT

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

(1) Whether overhead property used by a federal contractor in the performance of government contracts, the costs of which are allocable in accordance with accepted accounting principles to such performance, may, consistent with applicable California and federal law, be subjected to California ad valorem property tax.

(2) Whether such overhead property, pursuant to § 52-232-16(d) of the Federal Acquisition Regulations (48 CFR § 52.232-16) becomes property of the United States Government.

CORPORATE DISCLOSURE STATEMENT

Respondent Northrop Grumman Corporation, a Delaware corporation, has no parent corporation, nor is there any publicly held company which owns 10% or more of Northrop Grumman Corporation's stock.

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STATEMENT OF THE CASE

This is a tax refund action brought by Respondent with respect to property taxes levied by Petitioner on tangible personal property, such as perishable tools, equipment, supplies and technical books,[1] procured and used by Respondent in the performance of its contracts with the federal government. Respondent is a contractor which designs and manufactures aircraft and aircraft components under contracts with both the United States Government ("Government") and private commercial customers. During the tax years 1987 to 1995 Respondent designed and manufactured both military aircraft, such as the B-2 Stealth Bomber and the F-18 fighter, and commercial aircraft, such as the fuselage assembly of the Boeing 747 airliner, at plants

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1. Perishable tools include abrasive bands, bolts, cloths, disks, spiral points, adapters, anodic racks, batteries, bits, brushes, clamps, cleaners, counter sinks, drills, extractors, fasteners, files, gauges, hammers, mallets, plyers, punchers, reamers, wrenches and the similar. ¶4, Stip. Of Facts. Minor equipment includes office equipment, machinery and equipment, and factory equipment used in the performance of Respondent's contracts. *Id.* at ¶5. Supplies include material and supplies on hand that do not directly enter into finished products but are necessary for day-to-day administrative and production efforts, such as office supplies, drafting room supplies, safety equipment, paints, chemicals, oils, acids, adhesives, gloves and common production supplies such as nuts, bolts, screws and nails. *Id.* at ¶6. Technical books include publications commonly published by governmental or aerospace industry organizations which contain general or specific information used or referred to by Respondent in its performance of contracts, such as material specifications (strength, stress or wear tolerance), government or industry standards for aeronautical or radar design or manufacture, industry standards or procedures for material fastening and the similar. *Id.* at ¶7

located in Los Angeles County. Each of Respondent's Government contracts incorporated the "progress payment" clause of § 52.232-16 of the Federal Acquisition Regulations (48 C.F.R. § 52.232-16). This clause, in turn, included the "progress payment title clause" (found at subdivision (d) thereof), which transferred title in property allocable to contract performance, to the Government. Respondent contends, and the court below found, that pursuant to this title clause the portion of the subject perishable tools, equipment, supplies and technical books allocable in accordance with generally accepted accounting principles to the performance of contracts between Respondent and the Government (hereinafter "the Property"), was owned by the Government, and thus not taxable.[2] Petitioner, in contrast, asserts (i) that the progress payment clause passed only a security interest, and not title, to the Government; (ii) that in any case the Government's interest, whether ownership or security, inhered only in property directly charged to a particular Government contract (not the indirectly charged, or "overhead" property, at issue herein); and (iii) that irrespective of title, Respondent was subject to tax based upon its beneficial possession or control of the Property under California *Revenue and Taxation Code* § 405.

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2. Respondent contends that the tax was improper both because Respondent did now own the property so as to be taxable thereon, and because the federal government's property interest is constitutionally immune from taxation. *United States et al. v. Allegheny County*, 322 U.S. 174, 176-177; 64 S. Ct. 908, 910-911; 88 L. Ed. 1209, 1213-1214 (1994).

REASONS FOR DENYING THE PETITION

Certiorari should be denied in this matter for each of the following reasons:

1. The great weight of the law plainly supports both (i) that the progress payment title clause passes title, and not just a lien, to the federal Government; and (ii) that such title passage operates equally with respect to both direct and indirect property, allocated to contract performance.

2. The Petition raises no substantial federal issue because (i) the taxability of the Property below ultimately turned on state rather than federal law; and (ii) in any case, a state court's construction of the progress payment title clause in state tax litigation imports negligible impact on federal law or interests.

3. The decision below does not conflict with any decision of this Court, or of a United States Court of Appeals; and

4. Petitioner has not otherwise met its burden of demonstrating "compelling reasons" for the grant of certiorari. (Sup. Ct. R. 10)

ARGUMENT

I. The California Appellate Court Correctly Found That The Progress Payment Clause Passed Title, And Not A Mere Lien, To The Federal Government.

The progress payment title clause (48 C.F.R. § 52.232-16) reads in relevant part as follows:

> (d) *Title.* (1) Title to the property described in this paragraph (d) shall vest in the Government. Vestiture shall be immediately upon the date of this contract, for property acquired or produced before that date. Otherwise, vestiture shall occur when the property is or should have been allocable or properly chargeable to this contract.
>
> (2) 'Property,' as used in this clause, includes all of the below-described items acquired or produced by the Contractor that are or should be allocable or property chargeable to this contract under sound and generally accepted accounting principles and practices.
>
> (i) Parts, materials, inventories, and work in process;
>
> (ii) Special tooling and special test equipment to which the Government is to acquire title under any other clause of this contract;
>
> (iii) Nondurable (i.e. noncapital) tools, jigs, dyes, fixtures, molds, patterns, taps, gauges, test equipment and other similar manufacturing aids, title to which would not be obtained as special tooling under subparagraph (ii) above; and

> (iv) Drawings and technical data, to the extent the Contractor or subcontractors are required to deliver them to the Government by other clauses of this contract."

48 C.F.R. § 52.232-16(d).

The intent of the progress payment title clause to vest title, and not just a lien , in the Government is plain on the face of the regulation. *Id.* That the Government intends to take title to its contractors' property in exchange for progress payments, is also long supported in the federal case law. *United States vs. Ansonia Brass & Copper Co.* (1910) 218 U.S. 452, 466-467; 81 S. Ct. 49, 52-53; 54 L. Ed. 1107, 1113. *In Re American Boiler Works* (3d Cir. 1955) 220 F.2d 319, 320-321. *Shepard Engineering Company vs. United States* (8th Cir. 1961) 287 F.2d 737, 741.

In the *American Boiler Works* case the court plainly stated:

> "But one does not need a citation of decided cases to understand the language above quoted in Article 3 of the contract between the parties. It is as clear as English words can make it. The title, both to the vessels and to the materials, vested in the government with no ifs, ands or buts. And without any mention of payment as a prerequisite thereto.

In Re American Boiler Works, supra, 220 F.2d at 320-321.

The 1982 decision of the Court of Claims in *Marine Midland Bank vs. United States* (Ct. Cl. 1982) 687 F.2d 395; 231 Ct. Cl. 496 that the progress payment clause creates only a security interest constitutes a distinct minority of one. In addition to the above authorities to the contrary, all decisions after *Marine Midland* have also disagreed with, and declined to follow, its holding. *In Re American Pouch Foods, Inc.* (7th Cir. 1985) 769 F.2d 1190, 1193-1196, *cert. denied*, 475 U.S. 1082; 106 S. Ct. 1459; *First National Bank of Geneva vs. United States* (Ct. Cl. 1987) 13 Cl. Ct. 385, 387; *In Re: Verco Industries* (1982, BAP, 9th Cir.) 27 B.R. 615, 619-620; *In Matter of Double H Products* (1972, 3d Cir.) 462 F.2d 52, 54-55; *Hughes Aircraft Company vs. County of Orange* (2002) 96 Cal. App. 4th 540, 557-558, 117 Cal. Rptr. 2d 601, 614; *Strayhorn, Comptroller vs. Raytheon E Systems* (2003) 101 S.W.3d 558, 569-570; *Motorola Inc. vs. Arizona Dept. Of Revenue* (1999) 196 Ariz. 137, 144; 993 P.2d 1101, 1108; *McDonnell Douglas vs. Director of Revenue* (1997) 945 S.W.2d 437, 440-441.

That the progress payment title clause passes title, and not just a lien, was also strongly confirmed by Congress' enactment in 1997 of subdivision (h) of 10 U.S.C. § 2307, as follows:

> (h) Vesting of title in the United States. If a contract paid by a method authorized under subsection (a)(1) [includes progress payments] provides for title to property to vest in the United States, the title to the property shall vest in accordance with the terms of the contract, regardless of any security interest in the property that is asserted before or after the contract is entered into.

10 U.S.C. § 2307(h) [bracketed language added].

Finally, in addition to the forgoing regulatory, statutory and case law, the Department of Defense's administrative construction of the progress payment clause is decidedly that the Government's interest is one of ownership, and not a mere lien:

> The Department of Defense, General Services Administration, and National Aeronautics and Space Administration have decided to withdraw six proposed rules. These rules appeared between 1989 and 1992 and have subsequently been determined to be unnecessary, incorporated into other rules, or need further review.
>
> * * *
>
> **FAR Case 89-11, Title to Property Under the Progress Payment Clause.**
>
> The proposed rule, published May 1, 1989 in the Federal Register (54 FR18631), is hereby withdrawn, as agreed by the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council. The proposed FAR clarifications published for public comment have been determined to be unnecessary because the current FAR adequately covers issues addressed by the proposed rule. The rule proposed a change to the progress payments clause of FAR 52.232-16. The Councils published the proposed rule to assist in assessing whether the FAR should be revised to emphasize that it is and always has been the intent of the FAR that the interest taken by the Government in property covered by the clause

> is title in the form of ownership, and not a mere lien. The Councils have determined that there is no need to clarify the intent of the FAR. Contracts containing the Progress Payments Clause clearly reflect the intention of the parties to grant title to the property to the Government and not grant merely a lien.

59 Federal Register 5750-5751, Federal Acquisition Regulation, Withdrawal of Proposals, FAR Case 89-11.

Thus, it is apparent that each of (i) the clear language of the progress payment clause itself, (ii) the overwhelming weight of case and statutory law; and (iii) contemporaneous administrative construction by the Department of Defense[3], unequivocally support the progress payment clause's passage of title, and not a mere lien, to the Government.

II. The California Appellate Court Correctly Found That The Progress Payment Title Clause Transfers Title To Both Indirect And Direct Property.

Direct property is property the costs of which are directly charged to a single Government contract. 48 C.F.R. § 31.202(a). Indirect property is property the costs of which are indirectly charged across multiple contracts, Government or otherwise, in accordance with accepted accounting

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3. It is well settled that the construction of a statute by those charged with its execution should be followed absent compelling indication that it is wrong, and particularly where the same construction is ratified by subsequent positive Congressional action as in this case. *Red Lion Broadcasting vs. FCC* (1969) 395 U.S. 367, 381-382; 89 S. Ct. 1794, 1801-1802; 23 L. Ed. 371, 383-384.

principles. 48 CFR 31.203.[4] The types of Property at issue herein are indirect property, having been both incurred and employed in common, in the performance of both Government and commercial contracts.

It is clear from the language of the progress payment title clause itself, that the clause comprehends both direct and indirect property. It broadly references "materials" and "inventories" used in contract performance, as well as specifically enumerated shop sundries such as "nondurable (i.e. noncapital) tools, jigs, dyes, fixtures, molds, patterns . . . and other similar manufacturing aids" which were "allocable or properly chargeable to this contract under sound and generally accepted accounting principles." 48 C.F.R. § 52.232-16(d)(2). The Property in this case, stipulated to be both non-capital and properly allocated to the performance of Government contracts, and consisting of items fitting both the general and specific descriptions of the clause [Stip. of Facts, ¶4, 5, 6,7 & 9], plainly falls within the purview of the progress payment title clause.

Multiple state courts have, consistent with the California appellate court herein, directly addressed this issue and confirmed that the progress payment title clause passes title in "overhead" property to the Government for state tax purposes. In *Aerospace Corporation vs. State Board of Equalization* (1990) 218 Cal. App. 3d 1300; 267 Cal. Rptr. 685, bulk supplies and equipment very similar to those at issue herein (such as batteries, resistors, raw metals or plastics, perishable tools and janitorial or office supplies

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4. These accounting principles, entitled "Cost Accounting Standards" are detailed at Parts 30 and 31 of the Federal Acquisition Regulations, including but not limited to 48 C.F.R. § 31.203.

[*Id.* at 218 Cal. App. 3d at 1304 n.1 and 267 Cal. Rptr. at 687 n.1], were found properly allocable to contract performance, and thus owned by the Government:

> Aerospace's allocation of overhead materials to specific contracts based upon direct labor performed on each contract is a reasonable method of allocation which conforms to government regulations and generally accepted accounting principles. Under the provisions of the fixed price contracts at issue, title to that portion of the overhead property allocated to such contracts by Aerospace vested in the federal government upon allocation.

Id.

Precisely in accord with *Aerospace* are each of the cases of *Hughes Aircraft, supra*, 96 Cal. App. 4th 540, 550-552; 117 Cal. Rptr. 601, 608-610; (overhead property used in performing the fixed price Government contract was transferred to the Government and thus not subject to property tax); *Motorola, Inc. vs. Arizona Department of Revenue* (1999) 196 Ariz. 137, 139 and 143-144; (even materials consumed in the mental work that underpins the physical manufacturing work are transferred to the Government, such that a resale exemption from use tax applied); *Strayhorn, Comptroller of Texas vs. Raytheon E-Systems, Inc., supra*, 101 S.W.3d 558, 566-567 (title in overhead property consumed in performing Government contracts and charged as an indirect cost passes to the Government); *McDonnell Douglas Corporation vs. Director of Revenue, supra*, 945 S.W.2d at 439-441 (since contractor's overhead property was transferred to the Government pursuant to the progress

payment title clause the "resale" exemption from sales tax applied.)[5]

In summary, though the federal courts have not directly addressed the issue, each of (i) the plain descriptive language contained within the progress payment clause itself, and (ii) the great weight of well reasoned state court authority, strongly support the California appellate court's decision below, i.e., that title to the overhead Property at issue herein, stipulated by the parties to have been properly allocated to the performance of Government contracts, passed to the Government.

III. This Case Does Not Raise A Substantial Federal Question.

In addition to having been correctly decided below, it is clear that the issues of this case, as well as those in the similar previous state court decisions, bear heavily upon the application and construction of *state* tax statutes, and little upon federal law or interests. Although Respondent believes strongly that the cited state court cases (other than the aberrant *TRW* decision) correctly interpret the progress payment title clause to include overhead property, it is also indisputable that such cases would not bind in any respect the federal courts or agencies such as to import a substantial federal question herein. Finally, although Petitioner attempts

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5. Although the lone case of *TRW Space and Defense Sector vs. County of Los Angeles* (1996) 50 Cal. App. 4th 1703, 1717-1719; 58 Cal. Rptr. 602, 611-612 holds to the contrary, i.e. that the title clause does not pass title to overhead property, same has been roundly criticized in both *Motorola, supra*, 196 Ariz. at 142-145; 993 P.2d at 1106 and *Hughes Aircraft, supra*, 96 Cal. App. 4th at 550-557; 117 Cal. Rptr. at 608-614, and otherwise disregarded.

mightily to frame this case as one touching upon the scope of the Government's constitutional immunity from state taxation, this issue actually does not arise at all herein, as will now be discussed.

A. No Issue of Federal Immunity Arises Because The Subject Property Is Non-Taxable On Purely State Law Grounds.

Under each of Petitioner's and Respondent's factual constructions, Respondent admittedly enjoyed a valuable possessory interest in the Property, which Respondent possessed and used during its performance of its Government contracts. It is also undisputed that the value of a third party's possessory interest in Government property may constitutionally be subjected to state property tax, i.e. is not protected by the Government's immunity. *United States, et al. vs. County of Fresno* (1977) 429 U.S. 452, 462-464; 97 S. Ct. 699, 704-705; 50 L. Ed. 683, 692-693. *City of Detroit, et al. vs. Murray Corporation of America, et al.* (1958) 355 U.S. 489, 492-493; 78 S. Ct. 458, 459-461; 2 L. Ed. 441, 445-446. Thus, Respondent does not dispute that it held a potentially taxable (non-immune) possessory interest in the Property. However, this by no means raises an issue of Governmental immunity in this case, since it is also well settled that California law chooses not to impose tax on possessory interests in personal property. *See General Dynamics Corp. vs. County of Los Angeles* (1958) 51 Cal. 2d 59, 63-65; 330 P. 2d 794, 795-797; *TRW Space & Defense, supra*, 50 Cal. App. 4th at 1712-1714; 58 Cal. Rptr. 2d at 607-608.

In summary, Petitioner raises no substantial federal question herein, whether of federal immunity or otherwise. Not only did the California appellate court in this case correctly find that the federal progress payment title clause passed title to the overhead property, but even an incorrect state court construction of the title clause, in a state tax case, would have plainly negligible impact on the federal agencies or courts. Finally, the taxability of the Property in this case did not turn on a question of federal immunity, but rather, in the final analysis, on California's own legislative determination not to tax possessory interests in personal property. *Id.*

IV. The Decision Below Does Not Conflict With Any Decision Of This Court Or Of The United States Court Of Appeal.

The California appellate court decision below does not conflict with any decision of this Court, nor of its subordinate Courts of Appeal. The only potentially conflicting federal decision is that in *Marine Midland Bank vs. United States*, *supra*, 687 F.2d 395, a Claims Court case which stands alone in holding that the progress payment title clause passes a lien, and not title. However, its holding is directly contrary to an otherwise unanimous contrary body of law, and has not been followed by subsequent courts. *In Re American Pouch Foods, Inc.*, *supra*, 769 F.2d 1190, 1195-1196; *First National Bank of Geneva vs. United States*, *supra*, 13 Cl. Ct. at 387.

CONCLUSION

It is plain that this case is not certworthy. The Petition should be denied for each of the reasons that (i) the California appellate court correctly construed the applicable federal regulation, (ii) no substantial federal question, or split in federal legal authorities, is raised in the case, and (iii) the decision below as to the taxability of the Property is amply supported on independent state law grounds. Petitioner simply has not met its burden of demonstrating the required "compelling reasons" for the grant of certiorari.

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I. The Petition Raises a Compelling Issue.

Respondent's principle argument is that notwithstanding the *Northrop* decision below, federal contractor overhead could be made amenable to California property tax were the California Legislature simply to enact a statute allowing for a possessory interest assessment (i.e., a fractional interest assessment) of business personal property. However, this argument begs the question.

Here, the stipulated facts and the law (48 CFR §52-232-16(d)(6)) provide that the government does not take a reversionary interest in Northrop's overhead, and thus a fractional interest assessment of its property is not appropriate. On the other hand, the pertinent policy in California is that all property is to be uniformly and equally assessed unless otherwise required by law. (Cal. Const., art. XIII, sec. 1.)

The State Appellate Court opined in the case at bar that Northrop's overhead is federally-owned property that as a matter of federal law is categorically exempt from a state property tax assessment. The guiding principle in this area of the law is that an exemption from tax is the exception and not the rule. (Witkin, 9 Summary of California Law, 10th ed., Taxation, §4, pp. 28-29.) Consistent with this, the appropriate national policy should be that federal contractors bear their share of state property tax in the same manner and to the same extent as that borne by other business taxpayers in the jurisdiction, unless otherwise explicitly required by Congress. (*Id.*, §12, pp. 35-36.)

Federal contractor activity represents a significant portion of the overall national economy, and the competition for such activity at the state and local level is fierce.

However, the parameters for such competition should be explicit and consistent with law, not an auction of state sovereignty in a race to the bottom. (*See, e.g.*, Cal. Const., art. XIII, sec. 31.) The property tax is a chief revenue source for local government, including schools. The pertinent federal procurement laws should not lightly be interpreted to require the property tax exemption of federal contractors at the expense of the balance of the community. Thus, the petition raises an important issue worthy of this Court's review.

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